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Taxation

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TAXATION

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I. SALES TAX

A. APPLICATION OF THE TAX

TEXAS courts addressed a wide array of sales tax issues during the survey period. *Sharp v. Park 'N Fly of Texas, Inc.*¹ involved a taxpayer who provided airport parking and shuttle transportation services. The comptroller assessed a tax on the entire charge as a taxable parking service. The taxpayer argued it was providing two services, one taxable and the other nontaxable. The district court held in favor of the taxpayer,² finding Rule 3.315³ invalid because it unlawfully imposed sales tax on nontaxable transportation services, and finding that the comptroller's taxation of the taxpayer's transportation services violated the taxpayer's rights to equal protection and to equal and uniform taxation under the United States and Texas Constitutions by failing to tax other, similar transportation services.

The court of appeals reversed the lower court's decision and found that the sales price of a taxable service is the total amount for which the service is sold, without a deduction for transportation incident to the performance of the service.⁴ The court held that because the shuttle service occurred with, and was related to, the parking service, the shuttle service was "incident to" the parking service and thus included in the taxable sales price.⁵ The court distinguished taxation of other transportation service providers, such as taxis, limousines, and hotel shuttles, on the basis that such services were not related to parking services and were generally operated on a stand-alone basis. The court also found that the comptroller's adoption in 1989 of its policy of taxing transportation services provided incident to motor vehicle parking services and the enactment in 1995 of a clarifying rule amendment to reflect such policy was not uncon-

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1. 969 S.W.2d 572 (Tex. App.—Austin 1998, pet. denied).

2. See No. 95-12285 (200th Dist. Ct., Travis County, Tex. Apr. 11, 1997) (discussed in Cynthia M. Ohlenforst, Dorrill, & Goodin, *Taxation, Annual Survey of Texas Law*, 51 SMU L. REV. 1345, 1347 (1998) [hereinafter Ohlenforst, 1998 *Annual Survey*]).

3. 34 TEX. ADMIN. CODE § 3.315 (1998).

4. See 969 S.W.2d at 573, 575.

5. See *id.* at 576.

stitutionally retroactive.⁶

*Grocers Supply Co. v. Sharp*⁷ is a significant case because it illustrates a judicial willingness, given particular facts, to allow the comptroller to change a prior interpretation of law on a retroactive basis. The taxpayer in this case challenged the comptroller's policy change regarding the prior contract exception that exempts from an increase in the tax rate or enactment of a new tax those contracts executed prior to such rate change or new tax. In *Calvert v. British-American Oil Producing Co.*,⁸ the Texas Supreme Court determined the prior contract exemption was intended to apply only to three-party contracts, not to contracts between a buyer and seller when no third party was affected. However, in 1984, the comptroller began granting prior contract exemptions for two-party contracts. The taxpayer in *Grocers Supply* sought a refund relating to its electricity contract with Houston Lighting and Power Company under which sales tax was paid at the rate in effect at the time of payment. In May 1992, the comptroller changed his policy and decided to interpret the prior contract exemption as limited to two-party contracts, based on *Calvert*.

The court of appeals acknowledged that the comptroller had made no public announcement of the policy change and had retroactively applied the change in policy to pending refund claims. The taxpayer argued that the comptroller's retroactive enforcement of the policy change violated the comptroller's rule on prior contracts, contravened legislative intent, constituted an unlawful retroactive application of applicable law, and violated constitutional equal protection rights.⁹ The court determined that the policy allowing prior contract exemption to two-party contracts was found in the comments to the rule and was not actually found in the language of the rule itself. Therefore, the comptroller's change in policy did not violate the rule—only his interpretation of the rule. Further, the court determined that the comptroller's policy did not create a vested right; thus, the policy change during the pendency of the refund claim was not an unconstitutional retroactive application of law. Although noting that the comptroller's "actions do not foster the confidence and certainty in government upon which the people of this State are entitled to rely," the court found no violation of the doctrine of legislative acceptance and no constitutional violation of the right to equal taxation.¹⁰

The court in *Sharp v. Clearview Cable TV, Inc.*¹¹ determined that a cable company could purchase certain equipment tax free that was transferred to its customers for use in providing a taxable service. The case is significant for its recognition that traditional concepts concerning what constitutes a "resale" for sales tax purposes are difficult to apply to cer-

6. See *id.* at 578. Note that the 1995 rule amendment stated that it had a 1993 effective date.

7. 978 S.W.2d 638 (Tex. App.—Austin 1998, pet. denied).

8. 397 S.W.2d 839 (Tex. 1965).

9. See 978 S.W.2d at 641.

10. *Id.* at 645.

11. 960 S.W.2d 424. (Tex. App.—Austin 1998, pet. denied).

tain service transactions. As part of the cable service, the taxpayer purchases and installs equipment on the customer's premises. The comptroller asserted that the resale exemption was not applicable on the ground that the taxpayer did not transfer to the customer the care and control of the equipment installed outside the customer's premises (the antenna, converter, and connecting wire). The court acknowledged that the taxpayer was transferring only possession of the equipment and that both the taxpayer and the customer would have some degree of joint care and control over the property. According to the court, the comptroller's interpretation, which would require a complete divestiture of all rights in the property, would be unreasonable. The court based its holding that the sale for resale exemption is applicable on its conclusion that the customer had the primary possession of the equipment at issue.

Another services case, *Associated Technics, et al. v. Sharp*,¹² focuses on whether the asbestos abatement services performed by the taxpayers, constitute taxable repair and remodeling or nontaxable removal of hazardous waste. In a short letter ruling, the district court judge correctly concluded that the services at issue were not repair and remodeling and therefore were not taxable. The comptroller, however, consistent with his position in the underlying administrative cases, asserted that asbestos abatement involves two distinct services: extrication and disposal, and that the extrication is taxable as real property repair and remodeling. Under this line of analysis, it appears that the comptroller's interpretation would virtually always be at odds with the legislative intent that tax not be imposed on the removal of hazardous waste. The comptroller filed an appellate brief in this case on September 25, 1998.¹³

During every survey period, hundreds of comptroller decisions address sales tax issues. The availability of the occasional sale exemption is again an issue in many of these cases. In Decision 36,047,¹⁴ the comptroller again addressed the requirements for an occasional sale in the context of a company that sold most, but not all, of its assets. In October of 1994, the taxpayer sold eighty-nine pieces of construction equipment (including several motor vehicles) to another company. The taxpayer did not sell three motor vehicles that were used both in its general business and for personal use by its officers. Moreover (and more troubling for the taxpayer), there were seventy-four additional items that taxpayer had owned prior to the sale. The evidence showed that some of these items had been abandoned prior to sale and that some were listed as having been sold to the purchaser, although the purchaser did not allocate any part of the purchase price to those items.

Section 151.304¹⁵ exempts from sales taxes the occasional tax of a taxa-

12. No. 96-04152 (345th Dist. Ct., Travis County, Tex. Mar. 12, 1998).

13. Another case addressing asbestos abatement is *Americo Abatement Contractors v. Sharp*, pending in Travis County District Court; this case focuses on whether certain items purchased by an asbestos abatement provider are taxable.

14. Tex. Comp. Pub. Acc'ts, Hearing No. 36,047 (July 14, 1998).

15. See TEX. TAX CODE ANN. § 151.304(a) (Vernon 1992).

ble item. Subsection (b)(2) defines one type of occasional sale as "the sale of entire operating assets of a business or of a separate division, branch or identifiable segment of a business."¹⁶ The tax division relied on the fact that subsection (d)(3) defines operating assets for purposes of "this section" to conclude that the definition of operating assets applies only when the sale of the assets is of a segment of a business. However, the administrative law judge's decision points out that, when the rule was revised in 1994 to refer to what had been section (d) as "subsection" (d), the revised rule made clear that the definition of operating assets applies not only to transactions that involve the sale of a separate division or branch, but also to the sale of the entire business. Because the three vehicles that were not sold to the company had not been used "exclusively" by the business being sold, the taxpayer could hold those assets out of the sale and still qualify for the occasional sale exemption.

The taxpayer in Decision 36,047 also asserted that, in another context (concerning successor liability), Texas had interpreted "all" to mean "substantially all" or at least eighty percent,¹⁷ so that a sale of eighty percent of its assets was sufficient to constitute a sale of "all" of its operating assets. The comptroller's decision held, however, that the "substantially all" language applies only to the occasional sale exemptions described in subsection (e)(3) (i.e., transfers without change in ownership) and does not apply to the sale of assets.¹⁸ Similarly, the taxpayer failed to prevail with its argument that it had withheld from sale only a "de minimus" number of assets.

However, the taxpayer ultimately prevailed because it demonstrated that the other assets at issue had actually been sold to the purchaser, even though they were not taken into account in the price allocation. This evidence, therefore, established that the taxpayer had sold its entire operating assets.¹⁹

As technology continues to advance, a multitude of comptroller decisions and taxability response letters evidence the difficult challenge applying Texas sales and use tax laws to a rapidly changing world. Numerous recent comptroller decisions and letters, for example, interpret the taxation of various internet services.²⁰ These interpretations are important to note because they reflect the continuing difficulty of defining accurately the scope and taxability of internet-related services. The Texas Internet Tax Policy Working Group met at the comptroller's offices once a month throughout virtually the entire survey period to focus on the

16. *Id.* § 151.304(b)(2).

17. *See* 34 TEX. ADMIN. CODE § 3.316(e)(3) (1998) (concerning occasional sale exemption requirements).

18. *Tex. Comp. Pub. Acc'ts*, Hearing No. 36,047.

19. The decision also addresses certain other occasional sale issues, confirming that a taxpayer that holds a sales tax permit may not make an occasional sale consisting of "one or two sales of taxable items" during a twelve-month period.

20. *See e.g.*, Ltr. 9811967L (Nov. 5, 1998) (internet access is a taxable information service); Ltr. 9612155L (Dec. 11, 1996) (providing internet server space is data processing); Ltr. 9512L1386B04 (Dec. 21, 1995) (creation of web page is taxable data processing).

many policy issues underlying taxation of the internet, including reviewing comptroller policy and interpretation.

The Working Group, which included both comptroller and non-comptroller representatives, ultimately concluded that, to encourage business growth in Texas and to avoid the administrative quagmire of attempting to distinguish internet-related services from other data processing and information services, the Texas Legislature should repeal both the sales tax on data processing and the tax on information services.²¹ The comptroller has faced an increasing number of cases involving sales or use tax on telecommunications in recent years. One of several recent cases is Decision 32,318,²² which focused on private line services. The administrative law judge reviewed both the statutory and regulatory history concerning telecommunications services (both of which illustrate that lawmakers were focusing on telephone-type services when they enacted the sales tax on telecommunications) and concluded that private line services are taxable telecommunication services, regardless of whether the tax division has shown that there is an actual transmission conveyance or routing. The Decision, therefore, concludes that “merely making the private lines available for the use of its customers, for consideration, constitutes, in and of itself, the provision of taxable telecommunications services.”²³

Another telecommunications case, Decision 31,335,²⁴ presented a fact pattern that, in many respects, has become more frequent in the telecommunications age. A taxpayer acquires long-distance services from another company and makes those services available, along with services of its own, to a customer. In this case, the taxpayer’s profit came from the differential between the rates charged to its customers and the volume discount rates at which it was able to buy telecommunication services, plus (for some of the audit period) an additional fixed management service fee. The tax division initially took the position that both the “volume based management fee” and the “fixed management services charge” were taxable as telecommunication services. However, after the hearing, and taking into account the fact that the invoices had a separate entry for the fixed management fees as “Management Services,” the tax division agreed that those fees were not taxable.

Although the taxpayer took the position that it was not selling telecommunication services at all, the administrative law judge concluded that the taxpayer purchased long-distance services from other companies and then resold them to its clients, so that the taxpayer was indeed in the business of “reselling telecommunication services.”²⁵ The administrative

21. See REPORT OF TEXAS INTERNET TAX POLICY WORKING GROUP 13 (Jan. 1999). The Working Group also recommended legislative changes to ensure, among other issues, that the mere storage of software on a server in Texas would not create nexus for the software user.

22. Tex. Comp. Pub. Acc’ts, Hearing No. 32,318 (Dec. 17, 1997).

23. *Id.*

24. Tex. Comp. Pub. Acc’ts, Hearing 31,335 (Dec. 29, 1997).

25. See *id.*

law judge also declined to adopt the taxpayer's argument that its management services were the "essence of the transaction" so that the transaction was not taxable. (The Decision, in fact, includes an interesting discussion of whether, in the comptroller's view, the "essence of the transaction" test applies to mixed services transactions.) However, the administrative law judge concluded that the taxpayer was actually selling two services: taxable telecommunications and nontaxable management services.²⁶

The tax division argued that the entire amount charged by the taxpayer was subject to tax on the ground that the two services were provided for a lump sum amount. Moreover, the tax division argued that the sales tax services rules, which include the "five percent provisions" that allow either the service provider or the purchaser to later establish, through documentary evidence (including internal records), what portion of a lump sum charge is attributable to the performance of both taxable and nontaxable services, should not be available to the taxpayer.²⁷ The tax division based this assertion on the fact that Rule 3.344²⁸ does not specifically include this language, although the language appears in the rules on data processing, security services, information services, and certain other services. The judge, however, correctly concluded that there appears to be "no rational basis" for allowing some taxpayers who provide mixed services (i.e., a taxable service and a nontaxable service) to be treated differently, and that if taxpayers who provide mixed services that do not involve telecommunications are entitled to show what portion of their services are taxable, the providers of telecommunications services should be allowed to do the same.²⁹

Another case that addresses the scope of "telecommunications services" is Decision 35,703.³⁰ The taxpayer in this case provided food commodity market information to its customers through various forms of media, including telephone, fax and radio frequency transmissions. The taxpayer contended that its services were not taxable information services, but were telecommunications. This is an understandable argument given how broadly the comptroller has construed "telecommunications." If characterized as telecommunications, the services would have been treated as New Jersey services, rather than Texas, services. However, the comptroller concluded that the taxpayer was providing information services.³¹

26. *See id.*

27. *See, e.g.*, 34 TEX. ADMIN. CODE § 3.330(d)(2) (1998) (noting that if nontaxable unrelated services and taxable services are sold for a single charge, and the taxable portions more than five percent of the total, "the total charge is presumed to be taxable," although the buyer or seller may later establish the actual percentage that is for nontaxable services).

28. 34 TEX. ADMIN. CODE § 3.344 (1998) (dealing with telecommunications).

29. *See id.*

30. Tex. Comp. Pub. Acc'ts, Hearing No. 35,703 (Nov. 12, 1997).

31. *See id.*

More food for thought? In Decision 34,216,³² a taxpayer successfully challenged the sampling methodology used to determine its sales tax liability. The taxpayer, which operated gas stations with convenience stores, also made food stamp sales. The comptroller agreed that the taxable sales base should not include the food stamp purchases. However, as part of its sampling methodology, the auditor did not allow the reduction in taxable sales attributable to food stamps to the extent that the reduction exceeded zeroing out the additional taxable sales the auditor proposed adding to that particular period. Thus, the taxpayer's credit for food stamp sales was not allowed on an aggregate basis against total additional taxable sales added by the audit—only on a monthly basis and only to the extent the reduction did not exceed a zeroing out of additional sales. Taxpayers who have been frustrated during the administrative hearing process will love this case, if for no other reason than because the administrative law judge noted: "The Tax Division has offered no real rationale for not carrying over credits for food stamp purchases from one tax period to another stating only that: 'This is not allowed.'"³³ The administrative law judge correctly concluded that the result of the tax division's methodology was to deny the taxpayer the exemption to which it was entitled and therefore the audit should be amended to allow credits for exempt food stamp sales to be carried over from one monthly audit period to another.³⁴

The oil and gas company that was the taxpayer in Decision 35,899³⁵ purchased and used a weekly information service. Although the taxpayer had oil and gas exploration and production operations in New Mexico, those operations were overseen by the Midland Odessa office during the audit period. The decision focuses both on what constitutes information service as well as on what constitutes multi-state use. The taxpayer argued that the tax assessed for the information services should be allocated to the identifiable segments of its business offshore or in other states, including New Mexico. The tax division argued, on the other hand, that the information services were used at the division headquarters in Midland. The administrative law judge accepted the tax division's analysis (perhaps over-simplified) that the decision-making as to exploration and production must occur in the Texas offices so the services must be used in those offices.³⁶

Although the facts of this particular case may have supported this conclusion, it is worth noting that, on a troubling number of occasions, the comptroller's auditors have asserted that data processing and/or informa-

32. Tex. Comp. Pub. Acc'ts, Hearing No. 34,216 (July 13, 1998).

33. *Id.* After the survey period, legal counsel on the comptroller's staff commented that hearings attorneys must include both rationale and legal authority to support tax division assertions. Although many tax division attorneys already do so, the more official emphasis on rationale and legal authority should make good briefing more frequent.

34. *See id.*

35. Tex. Comp. Pub. Acc'ts, Hearing No. 35,899 (July 13, 1998).

36. *See id.*

tion services must necessarily be used at a company's headquarters rather than at the location of its outlying offices, notwithstanding the contrary legislative intent and regulatory interpretation concerning sourcing services. Fortunately, taxpayers who are able to present evidence showing that the benefit of the services occurs in other states are often able to prevail.

Another case focusing on determining where the benefit of services occurs is Decision 36,649.³⁷ The taxpayer in this case, like the state in Decision 35,899,³⁸ argued that the security services performed for certain clients are presumed to be used at the client's principal place of business. The taxpayer based its contention on its determination that its client's Texas offices were not "identifiable segments" of the client's business within the meaning of Rule 3.333(o)(2).³⁹ The taxpayer is an insurance claims investigation agency based in Illinois, and the services at issue involved clients that requested service in a Texas office; however, the object of the surveillance was located out of state. On this fact pattern, the taxpayer argued that a service that cannot be assigned to an "identifiable segment" of a customer's business is generally presumed to be used to support the administration or operation of the customer's business generally. In this case, the taxpayer argued, the security service is presumed to be used at the customer's principal place of business.

The taxpayer also asserted that because the term "identifiable segment" is not defined in the regulations dealing with services, it should be interpreted as defined in the occasional sale rule. (Rule 3.316(d)⁴⁰ provides guidance as to the meaning of "identifiable segment" in the context of determining what constitutes a sale of the operating assets of an "identifiable segment" of business.) However, the administrative law judge declined to accept the taxpayer's logic "regardless of its allure," and concluded instead that the determination of whether a separate identifiable segment of the business exists "turns on the organizational and operational structure of the customer's business and the disputed location's place in that structure," further noting that such a determination is necessarily fact-oriented.⁴¹

The Decision ultimately held for the taxpayer, based on the judge's finding that the tax division failed to meet its burden of proof.⁴² Significantly, the judge pointed out that the tax division had had an opportunity to seek additional information from the taxpayer through formal and informal discovery and that "[s]ince the tax division has not complained that [taxpayer] failed to provide any documents requested by the Tax Division, the Tax Division cannot object that its failure to make a prima

37. Tex. Comp. Pub. Acc'ts, Hearing No. 36,649 (Aug. 10, 1998).

38. Tex. Comp. Pub. Acc'ts, Hearing No. 35,899. *See supra* note 34 and accompanying text.

39. 34 TEX. ADMIN. CODE § 3.333(o)(2) (1998).

40. 34 TEX. ADMIN. CODE § 3.316(d) (1998).

41. *See* Tex. Comp. Pub. Acc'ts, Hearing No. 36,649.

42. *See id.*

facie showing was due to [taxpayer's] failure to produce requested documents."⁴³ Although the Decision is favorable to the taxpayer, it is troubling for several reasons, including its refusal to give weight to long-standing comptroller interpretation of the phrase "identifiable segment." The Decision's apparent invitation to the tax division to escape (easily?) its burden of proof by requesting documents that the taxpayer is unable to produce is also troubling. On the other hand, the decision is noteworthy for correctly pointing out that services that are not taxable because they are multi-state services are not "exempt services," so that the standards for proving an exemption do not apply.

Once again, the comptroller issued multiple decisions that address construction taxability issues. Decision 34,087,⁴⁴ for example, involved a contractor/taxpayer who claimed that materials and equipment he purchased pursuant to a separated contract involving work for an exempt entity were exempt from sales tax and that materials and equipment purchased pursuant to separated contracts with developers improving real property previously dedicated to exempt entities were also exempt. However, the administrative law judge found that the taxpayer's contracts were lump-sum contracts rather than separated contracts.⁴⁵ The taxpayer's efforts to "interpret or clarify" the contracts through documents that were signed after the date of the original agreement and (more importantly) after the date the work was completed did not, according to the administrative law judge, in any way alter the findings that the agreement was a lump-sum contract. The case is noteworthy not so much for its finding on the particular facts at issue, but for its reiteration of the controller's policy "that an amendment made before the completion of the contract will be recognized for sales tax purposes."⁴⁶ The taxpayer's second contention, dealing with work for developers with respect to property dedicated to tax exempt entities, also rested on a combined fact-finding and legal conclusion. The case focuses on legal premise that the title to purchased materials must pass to the developer *prior* to their incorporation into realty. Based on the fact-finding that there was nothing in the record to show that the title to the purchased material had passed to the developer prior to incorporation, tax was imposed on those contracts as well.⁴⁷

43. *Id.*

44. Tex. Comp. Pub. Acc'ts, Hearing No. 34,087 (Jan. 14, 1998).

45. See *id.*; see also 34 TEX. ADMIN. CODE § 3.292 (1998) (for the distinction between, and the different tax treatment of, separated and lump sum contracts).

46. Tex. Comp. Pub. Acc'ts, Hearing No. 34,087.

47. See also Tex. Comp. Pub. Acc'ts, Hearing No. 35,793 (Apr. 15, 1998) (addressing the taxability of certain services provided pursuant to a "Management and Concession Agreement" between a taxpayer and the city); Tex. Comp. Pub. Acc'ts, Hearing No. 36,079 (July 7, 1998) (transmission line contract, which involved reusing about ten percent of the original materials was not new construction); Tex. Comp. Pub. Acc'ts, Hearing No. 36,044 (July 29, 1998) (installation of vapor recovery system, including new pipeline, was not new construction). [Notice a trend?].

Decision 36,515⁴⁸ illustrates again how broadly section 151.007⁴⁹ of the Tax Code can be construed. The taxpayer sold and rented general safety equipment and supplies, such as fire extinguishers and safety equipment for oil and gas operations, and also supplied the instructing and training with respect to certain safety matters. The taxpayer argued that it should not be required to pay tax on instruction and training, safety supervisor services, disassembly charges of the equipment, or certain maintenance or fire extinguisher services. However, relying on the § 151.007(b) provision that the amount for which a taxable item is sold "includes a service that is a part of the sale,"⁵⁰ the auditor scheduled these items for tax. After discussing the cases cited by both the taxpayer and the tax division, the administrative law judge focused on the fact that certain of the services at issue (specifically safety instruction and safety supervisor) were included in the audit only if they accompanied the rental of safety equipment and concluded that this safety instruction and supervisor were part of the equipment rental, the equipment rental being the essence of the transaction.⁵¹

The case is noteworthy for its discussion not only of nontaxable services that become taxable in the comptroller's view, but also for the case's comments on the burden of proof. The decision points out that because the taxpayer raised the exclusionary issue of maintenance, the tax division was required to establish on its face both that the services at issue were included in taxable services (real property and repair services in this case) and that they were not the type of maintenance intended to be excluded from these services. However, based on the finding that the taxpayer had—and had failed to meet—the responsibility to provide adequate records upon request, the taxpayer nonetheless lost.

The taxpayer in Decision 36,344⁵² purchased ribbons, awards, t-shirts, and other items to provide to public and private schools in the course of providing its nontaxable instructional services. Because the taxpayer did not bill its school customers for t-shirts, etc., the comptroller viewed the taxpayer as having made a use of those items rather than having sold them. Therefore, the taxpayer owed use tax on these items of tangible personal property. This decision is consistent in many respects with the comptroller's policy on mobile telephones that require the provider of a mobile telephone to pay use tax on a phone that is "given" to a customer in connection with the customer's agreement to purchase telephone services from the seller.⁵³ This case is also noteworthy because it expresses again the comptroller's opinion that, if an issue for an audit period had

48. Tex. Comp. Pub. Acc'ts, Hearing No. 36,515 (Mar. 6, 1998).

49. TEX. TAX CODE ANN. § 151.007(b) (Vernon 1992 & Supp. 1998).

50. *Id.*

51. See Tex. Comp. Pub. Acc'ts, Hearing No. 36,515.

52. Tex. Comp. Pub. Acc'ts, Hearing No. 36,344 (Mar. 3, 1998).

53. See also Tex. Comp. Pub. Acc'ts, Hearing No. 36,619 (Jan. 12, 1998) (car dealer owes use tax for auto parts provided to customers without charge as part of its warranty work).

not yet been resolved, a taxpayer must file subsequent returns consistent with the auditor's position (and thereby risk making an interest-free loan to the state)⁵⁴ or pay a penalty.⁵⁵

B. REGULATORY DEVELOPMENTS

The comptroller proposed or adopted several regulation amendments to reflect 1997 legislative changes to the sales and use tax provisions. For example, the comptroller amended Rule 3.285, regarding sales for resale, to conform to the 1997 amendment to section 151.154(f)⁵⁶ stating that if a purchaser uses a taxable item purchased tax free for resale as a trade-in on the purchase of another taxable item, the purchaser is liable for sales tax on the original purchase price of the taxable item used as a trade-in.⁵⁷

Rule 3.297⁵⁸ was amended to make clarifications regarding the exemption for commercial vessels. Additional amendments were adopted as the result of 1995 legislation to exempt supplies used in electrochemical plating by persons repairing jet turbine aircraft engines; to exempt electricity and natural gas used in off-wing processing or repair for licensed or certificated carriers; to extend the exemption to tangible personal property that is necessary for the normal operations of the aircraft and is pumped, poured, or otherwise placed in an aircraft owned or operated by a common carrier or flight school; to exempt aircraft purchased for use by flight schools; to allow flight students to issue exemption certificates for certain rentals; and to exempt items used in the repair, remodeling, or maintenance of flight school aircraft.⁵⁹

In line with 1997 legislative amendments to amusement services, the comptroller amended rule 3.298⁶⁰ to allow resellers of tickets to deduct from reportable taxable sales the face value of tickets, less the included sales tax, purchased from non-permitted purchasers, provided the tickets had tax included when purchased.⁶¹

Amendments have been proposed to rule 3.316⁶² concerning occasional and tax-free sales to reflect the 1997 legislative change imposing a \$5,000 ceiling on the selling price of a taxable item that qualifies as an exempt sale by certain academic or student organizations.⁶³

54. Texas does not pay interest on refunds granted through administrative, rather than judicial, channels. However, Comptroller Carole Keeton Rylander, who became comptroller after the survey period, announced her intention to recommend a long-needed legislative change to authorize interest payment on such refunds. In the absence of such authority, taxpayers who pay more tax than they are ultimately found to owe have, in effect, made an interest-free loan to the state.

55. See also *infra* note 137 and accompanying text.

56. TEX. TAX CODE ANN. § 151.154(f) (Vernon Supp. 1998).

57. See 23 Tex. Reg. 7381 (1998) (codified at 34 TEX. ADMIN. CODE § 3.285).

58. 34 TEX. ADMIN. CODE § 3.297 (1998).

59. See 23 Tex. Reg. 8182 (1998) (codified at 34 TEX. ADMIN. CODE § 3.297).

60. 34 TEX. ADMIN. CODE § 3.298 (1998).

61. See 23 Tex. Reg. 7381 (1998) (codified at 34 TEX. ADMIN. CODE § 3.298).

62. 34 TEX. ADMIN. CODE § 3.316 (1998).

63. See 23 Tex. Reg. 2256 (1998) (34 TEX. ADMIN. CODE § 3.316) (proposed April 5, 1998).

Rule 3.329⁶⁴ concerning refunds available to enterprise projects and to qualified businesses in enterprise zones was amended as a result of 1997 legislation, which provides for the creation of defense economic readjustment zones and the designation of defense readjustment projects. The amendments set forth the definitions, refunds available, and refund requirements for such projects.⁶⁵

The comptroller amended the staff leasing services rule, Rule 3.364,⁶⁶ to reflect changes made by the 1997 legislation to the Labor Code, which regulates the staff leasing industry. The definition of "Staff Leasing Company" was amended to avoid the necessity of changing the comptroller's rule each time the Labor Code is changed concerning staff leasing services.⁶⁷

II. FRANCHISE TAX

A. APPLICATION OF THE TAX

The case *3 Beall Brothers 3, Inc. v. Sharp*⁶⁸ challenged the "additional tax" imposed by section 171.001⁶⁹ on the ground that it unconstitutionally imposes unequal tax burdens on similarly situated taxpayers. 3 Bealls Brothers' accounting year ended January 31. When it ceased doing business on August 2, 1993, according to the comptroller it owed the "additional tax" based on eighteen months. However, corporate taxpayers with a calendar year-end that dissolved on the same date paid the "additional tax" based only on seven months. The taxpayer relied heavily on *Bullock v. Sage Energy Co.*,⁷⁰ in which the court held that the comptroller's method of determining franchise tax liability was unconstitutional, arguing that the comptroller's interpretation of the statute treated similarly situated taxpayers differently. The taxpayer also raised other constitutional arguments, based on its contention that it had already paid the tax and that the "additional tax" was not related to services provided to the corporation by the state (which, after all, had ceased doing business) and that it did not have nexus for purposes of the additional tax. In a letter ruling, the district court judge concluded that Beall Brothers' argument that it should not pay the tax is valid, holding that: "There is no rational basis for fixing different measures of the additional tax time for computing [earned surplus] for similarly situated corporations, based solely on the accounting year used by the respective corporations."⁷¹

Another of the cases to reach the courthouse to challenge the applica-

64. 34 TEX. ADMIN. CODE § 3.329 (1998).

65. 23 Tex. Reg. 4311 (1998) (codified at 34 TEX. ADMIN. CODE § 3.329).

66. See 34 TEX. ADMIN. CODE § 3.364 (1998).

67. See 23 Tex. Reg. 4314 (1998) (codified at 34 TEX. ADMIN. CODE § 3.364).

68. No. 97-05710 (261st Dist. Ct., Travis County, Tex. June 25, 1998).

69. TEX. TAX CODE ANN. § 171.001 (Vernon 1992 & Supp. 1998).

70. 728 S.W.2d 465 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

71. No. 97-05710. The comptroller filed a Notice of Intent to Appeal. This case is significant because its holding would not be limited to versions of § 171.001 that are no longer in effect.

tion of the additional tax is *B&A Marketing v. Sharp*.⁷² B&A Marketing, a calendar-year-end taxpayer, dissolved on December 12, 1992, and was assessed the additional tax by the comptroller. Relying on a literal reading of the underlying Tax Code section as it was in effect from 1992 until 1994, B&A Marketing argued that the additional tax could be imposed only on corporations that are subject to the taxable capital but not to the earned surplus tax. Therefore, because B&A Marketing was not subject to taxable capital tax for the year at issue, it concluded (logically) that it could not be liable for the additional tax imposed by section 171.001. Like 3 Beall Brothers, B&A Marketing also argued that the statute was unconstitutional on the ground it discriminated against dissolved corporations and B&A Marketing further pointed out that, as a dissolved corporation, it had no nexus. The district court ruled in favor of B&A Marketing in August of 1998, concluding that under the literal language of the statute, B&A Marketing was not in the class of corporations subject to tax.⁷³

In *Arch Petroleum, Inc. v. Sharp*,⁷⁴ the court held that Series A convertible redeemable preferred stock obligations are debt and may be excluded from surplus. Arch Petroleum sold to Citicorp the shares at issue under an agreement that contained a mandatory redemption feature requiring Arch to pay seven million dollars for redemption, and a convertibility feature that allowed Citicorp to convert some or all of the preferred stock for common stock prior to the redemption date. The court found that the conversion feature did not cause the obligation to be contingent (and thus includable in surplus) because the conversion feature “did not render questionable *whether* the obligation had been incurred, but only *how* it would be satisfied—by cash or shares of common stock.”⁷⁵ Further, the court found that the obligation was measured in a certain amount of money since the seven million dollar redemption price was set by the parties to the agreement and was not an estimate or forecast. “[T]he statute requires only that the obligation be *measured* in an amount of money; there is no requirement that it be *satisfied* in that amount of money.”⁷⁶ The court concluded that exercise of the conversion option would not reduce or eliminate Arch Petroleum’s obligation; rather it would only have changed the form by which the obligation may be satisfied.

In the long-awaited *Texas Utilities Electric Co. v. Sharp*,⁷⁷ the court of appeals held that the value of future rental expense under long-term operating leases could not be deducted in calculating franchise tax. After examining the rules of statutory construction and the legislative history

72. No. 97-01522 (250th Dist. Ct., Travis County, Tex. Sept. 25, 1998).

73. See *id.* The comptroller filed a Notice of Intent to Appeal.

74. 958 S.W.2d 475 (Tex. App.—Austin 1997, no pet.)

75. *Id.* at 478.

76. *Id.* at 479.

77. 962 S.W.2d 723 (Tex. App.—Austin 1998, pet. denied).

and intent of Tax Code section 171.109,⁷⁸ the court held that in order for an obligation to meet the definition of "debt" and be deductible for franchise tax purposes, first the "debt" must be a liability under GAAP, and second, the obligation must satisfy the restricted definition of "debt" in section 171.109(a)(3)⁷⁹ (defining "debt" as any legally enforceable obligation measured in a certain amount of money which must be performed or paid within an ascertainable period of time). Although both the taxpayer and the tax division agreed that the future rental expense falls within the (a)(3) definition, both parties also agreed that the future operating lease rental expenses were not "debt" according to GAAP.

The taxpayer in Decision 36,769⁸⁰ relied on *Arch Petroleum*⁸¹ in asserting that the vested portion of the taxpayer's "Shadow Stock" should be excluded from surplus. In the now familiar scenario in which taxpayers argue that amounts are deductible from surplus for franchise tax purposes as debt and the comptroller argues (frequently successfully) that the amounts at issue are not deductible, the taxpayer argued that it should be allowed to deduct from surplus the liabilities arising in connection with its "Shadow Stock" plan. Employees of the company who received Shadow Stock were entitled to receive cash payments equivalent to the amount of a declared common stock dividend as well as to participate in the growth and appreciation of the Shadow Stock. Among the several important facts on which the taxpayer focused are the following: as of December 31 of any year, the vested number of Shadow Stock shares is capable of exact determination; the Shadow Stock Plan constitutes a "legally enforceable obligation" pursuant to section 171.109(a)(3);⁸² and the amounts are payable on demand. In declining to follow *Arch Petroleum*, on the grounds that the facts are different, the administrative law judge concluded that the amounts at issue in the comptroller hearing "do not qualify as debt under Section 171.109(a)(3) because they are not measured in a certain amount of money."⁸³ Concluding that even though the precise value of the vested portion could be calculated as of December 31, the administrative law judge focused on his finding that the taxpayer's actual liability remained unknown because each participating employee's surrender date was not yet determined.

Decision 32,421⁸⁴ involved an oil and gas company's contentions that its deferred income taxes were improperly included in surplus and that a portion of its percentage depletion, as reported on its federal tax return, was also improperly included in surplus. One of the issues addressed by this case is the treatment of "built-in gain" of a taxpayer that converted

78. TEX. TAX CODE ANN. § 171.009 (Vernon 1992 & Supp. 1998) (defining surplus).

79. *Id.* See also 962 S.W.2d at 727.

80. Tex. Comp. Pub. Acc'ts, Hearing No. 36,769 (June 16, 1984).

81. 958 S.W.2d 475.

82. TEX. TAX CODE ANN. § 171.109(a)(3) (Vernon 1992).

83. Tex. Comp. Pub. Acct's, Hearing No. 36,769.

84. Tex. Comp. Pub. Acc'ts, Hearing No. 32,421 (June 3, 1998).

from "C" to "S" status. Following its conversion from C corporation to S corporation, the taxpayer reported the tax on its built-in gain on its federal tax returns and on its financial statements. The taxpayer's financial statements for 1992 (four years after the conversion to "S" status) reflected the deferred income tax liability. The taxpayer characterized its position as unique in that it was a substantial company that elected "S" status, and the taxpayer noted that there were no specific accounting pronouncements to deal with its situation. Its evidence concerning accounting treatment established that the taxpayer had properly reported the deferred income taxes according to GAAP. The amount could, therefore, be deducted from surplus in accordance with section 171.109(i)(3),⁸⁵ which, for the year at issue, provided that deferred income taxes could be excluded from surplus to the extent recognized under GAAP.

The taxpayer did not prevail on its other primary contention, regarding its use of percentage depletion. The taxpayer argued that because it was entitled to use the federal income tax method in determining its franchise tax liability, and because the federal tax laws allow for depletion below an asset's cost, the taxpayer should be permitted to reduce its assets below cost, thereby reducing its taxable capital base. Although the administrative law judge originally ruled in the taxpayer's favor on this issue, in the final decision, he held in favor of the tax division, summarizing the issue as "whether the permitted use of an accounting method used for reporting federal income tax in lieu of using a GAAP accounting method overrides the fundamental statutory framework of the taxable capital component of the Texas franchise tax."⁸⁶ The judge therefore concluded that the taxpayer "cannot merely rely upon an accounting method used on its federal income tax to confer upon it substantive benefits that were neither intended to be granted by the legislature nor sanctioned by the framework of the Texas franchise tax."⁸⁷

Although it is too early in the statute's history to have published hearings decisions on the tax consequences of a Texas entity's relying on new law to convert into another entity (e.g., a corporation conversion into a limited partnership),⁸⁸ the comptroller has issued several rulings on such conversions in the last few months. These rulings indicate, consistent with prior comptroller policy, that an entity that is a partnership under Texas law will not be subject to franchise tax even if it elects to be taxed as a corporation for federal income tax purposes.⁸⁹

Decision 34,867⁹⁰ presented an interesting issue in the context of a life

85. TEX. TAX CODE ANN. § 171.109(i)(3) (Vernon 1992).

86. Tex. Comp. Pub. Acc'ts, Hearing No. 32,421. Does phrasing the issue in terms of whether an accounting method "overrides the fundamental statutory framework" give a good hint as to the ultimate outcome of this case?

87. *Id.*

88. See TEX. BUS. CORP. ACT ANN. § 5.17 (Vernon Supp. 1998) (added by Acts 1997, 75th Leg., ch. 375, § 32).

89. See, e.g., Ltr. 9806542L (June 17, 1998); Ltr. 9807637L (July 9, 1998).

90. Tex. Comp. Pub. Acc'ts, Hearing No. 34,867 (Aug. 18, 1998).

insurance company's treatment of compensation of its officers and directors for franchise tax purposes. The taxpayer argued convincingly (and correctly) that the officer/director compensation add-back⁹¹ did not apply to a life insurance company that was ultimately owned by a mutual life insurance company that had no shareholders. Section 171.110 requires that the compensation of officers and directors be added to a taxpayer's taxable income in determining its reportable taxable income for earned surplus purposes unless the corporation has no more than thirty-five shareholders. The taxpayer pointed out that because its ultimate parent is a mutual life insurance company that has no shareholders, it has fewer than thirty-five shareholders and, therefore, may not be required to add back the compensation of its officers and directors. The tax division argued unpersuasively (and incorrectly) that "shareholder" in the statute was intended to be interpreted broadly enough to include not only shareholders, but also policyholders. The administrative law judge, agreeing with the taxpayer that the statutory reference to the word "members" referred only to members of a limited liability company and not to policyholders of a mutual life insurance company, granted the taxpayer's contention.⁹² This case is also noteworthy for its analysis of the relevant rule and for its focus on the burden of proof question.

Other cases focus on interpretation of the relatively new section 171.1061,⁹³ which provides that an item of income included in the corporation's taxable earned surplus, other than dividends and interest, "that a state other than this state or a country, other than the United States, cannot tax because the activities generating that item of income do not have sufficient unitary connection with the corporation's other activities conducted within that state or country under the United States Constitution," is allocated to Texas if the corporation's commercial domicile is in Texas.⁹⁴

Decision 36,009,⁹⁵ for example, focused on whether a non-business income deduction claimed by the taxpayer should be allocated to New Jersey (the taxpayer's domicile) or apportioned to Texas. Decision 35,239⁹⁶ also addressed section 171.1061. In one of the longer decisions issued during the survey period, the administrative law judge discussed at length the taxpayer's two contentions, specifically whether its royalty income from "passive patents" was subject to apportionment and whether, if its income from the passive patents is apportioned, such income should be included in gross receipts everywhere. In this hearing, the taxpayer

91. See TEX. TAX CODE ANN. § 171.110 (Vernon 1992 & Supp. 1998) (requiring that compensation of certain corporate officers and directors be added to the earned surplus tax base).

92. Tex. Comp. Pub. Acc'ts, Hearing No. 34,867.

93. TEX. TAX CODE ANN. § 171.1061 (Vernon Supp. 1998).

94. *Id.*

95. Tex. Comp. Pub. Acc'ts, Hearing No. 36,009 (May 5, 1998).

96. Tex. Comp. Pub. Acc'ts, Hearing No. 35,239 (May 5, 1998) (After the survey period, the parties moved to dismiss this case on the basis of post-hearing briefs. *Id.* (Nov. 10, 1998)).

described its “active” patents as those that produced royalty income for the taxpayer pursuant to licensing agreements with foreign subsidiaries and others. The parties agreed that the royalties from the active patents are part of taxpayer’s unitary business. By contrast, the “passive” patents were not used for taxpayer’s business carried out in Texas. The administrative law judge concluded that the passive royalty income at issue was part of the taxpayer’s overall unitary business and that the taxpayer’s use of foreign subsidiaries to develop products and the foreign source of the income did not prohibit this income from being apportioned to Texas. The judge further held that the passive royalty income should be included in gross receipts everywhere.⁹⁷

In Decisions 35,797 and 35,798,⁹⁸ a corporate REIT successfully challenged the comptroller’s prior policy (evidenced by several letters to taxpayers between 1992 and 1995) that dividends to shareholders could not be deducted from reportable federal taxable income by REITs. Acknowledging that this was a case of first impression and adopting the reasoning of other states that have faced this issue, the judge held that net taxable earned surplus is computed by determining the corporation’s reportable federal taxable income, and that under the Internal Revenue Code the reportable federal taxable income for a REIT takes into account the deduction for the dividends paid to the shareholders. The tax division argued strongly (to no avail) that allowing the dividends paid deduction would result in REITs being treated differently from other corporations, that the legislature clearly intended that there be no such exemption, and that the comptroller’s long-standing policy had been accepted by the legislature. The case is significant both for its correct adherence to the statutory provisions and for the importance of the judge’s determination that earned surplus must be calculated by reference to federal taxable income.⁹⁹

The taxpayer in Decision 30,897,¹⁰⁰ an oil and gas company, established that both the financial accounting standards board and the SEC had promulgated standards for accounting and reporting by oil and gas companies to ensure that the reported values of oil and gas properties do not exceed the lesser of the assets’ net book value and their fair market value as measured in accordance with GAAP. The taxpayer’s evidence showed that these standards effectively created a “ceiling” for the value of the

97. See *id.*; see also *Polaroid v. Sharp*, No. 97-00785 (201st Dist. Ct. Travis County, Tex.) that also addresses unitary tax issues. Polaroid received a \$1 billion payment from Kodak in settlement of a patent infringement suit. In this case, apparently the first time a Texas court has addressed what is unitary income for franchise tax purposes, Polaroid argued that the tax effectively was a retroactive tax on its income and that single factor gross receipt was inappropriate, and that the income at issue was simply not unitary. See also *Tex. Comp. Pub. Acc’ts*, Hearing No. 36,858 (Sept. 30, 1998) (income from both royalties and sale of trademark was unitary income).

98. *Tex. Comp. Pub. Acc’ts*, Hearing Nos. 35,797-35,798 (Dec. 3, 1997).

99. See also *Tex. Comp. Pub. Acc’ts*, Hearing No. 35,800 (Jan. 21, 1998) (allowing a dividends-paid deduction to a closed-end investment company that elected to be treated as a regulated investment company (RIC) for federal income tax purposes).

100. *Tex. Comp. Pub. Acc’ts*, Hearing No. 30,897 (Dec. 9, 1997).

assets to which the standards (the "ceiling test") applied. The taxpayer further showed that to the extent the adjustments that resulted from the ceiling test were part of its contra-asset accounts for depreciation, depletion and amortization, those adjustments must be taken into account in computing surplus. Thus, section 171.109(i)(2),¹⁰¹ which specifically authorizes taxpayers to exclude from surplus, "to the extent they are in conformance with generally accepted accounting principles . . . a contra-asset account for depletion, depreciation, or amortization,"¹⁰² authorizes the taxpayer to exclude from surplus the ceiling test adjustment.

Decision 36,071¹⁰³ is another of several "throwback" cases issued during the last year. The taxpayer's sole contact with the State of California, to which it delivered goods, was solicitation of sales. The tax division and the taxpayer agreed that taxpayer's California solicitation activity did not exceed the scope of activities protected under Public Law 86-272.¹⁰⁴ Although the parties agreed that the receipts for California sales would not be "thrown back to Texas so long as the taxpayer was subject to tax in California," there appeared to be some inconsistency in determining exactly what "subject to taxation" means. An earlier proposed decision in another case, Decision 35,480,¹⁰⁵ concluded that Rule 3.557(e)(37)(I)¹⁰⁶ was in conflict with section 171.1032¹⁰⁷ (as in effect until January 1994), and would have provided precedent for a taxpayer victory in this case, given that the taxpayer had "constitutional nexus" with California. However, when the comptroller declined to adopt that proposed decision, he also declined to rule in the taxpayer's favor in this later case. Instead, the administrative law judge in Hearing 36,071, relied on the earlier case which held that:

The purpose of apportionment is to ensure that Texas fairly imposes a tax on its share of income earned by a corporation. If no other state can tax the income related to a sale of tangible personal property which originated in Texas, then it is fair to "throwback" that sale to Texas in the apportionment calculation.¹⁰⁸

Decision 36,071 is interesting for its focus on what "subject to tax" means, and on its discussion of California versus Texas law.

Decision 35,480¹⁰⁹ concerns the throwback, for earned surplus apportionment purposes, of sales receipts from tangible personal property shipped from Texas to states in which the taxpayer claimed to be "subject to taxation" based on constitutional nexus. Although the original proposed decision was in the taxpayer's favor (on the ground that section

101. TEX. TAX CODE ANN. § 171.109(i)(2) (Vernon 1992 & Supp. 1998).

102. *Id.*

103. Tex. Comp. Pub. Acc'ts, Hearing No. 36,071 (July 22, 1998).

104. Pub. L. No. 86-272, 73 Stat. 555 (codified as amended at 15 U.S.C. §§ 381-84 (1994)).

105. Tex. Comp. Pub. Acc'ts, Hearing No. 35,480 (July 7, 1998).

106. 34 TEX. ADMIN. CODE § 3.557(e)(37)(I).

107. TEX. TAX CODE ANN. § 171.1032 (Vernon 1992 & Supp. 1998).

108. Tex. Comp. Pub. Acc'ts, Hearing No. 36,071.

109. Tex. Comp. Pub. Acc'ts, Hearing No. 35,480.

3.557(e)(37)(I)¹¹⁰ should not be applied to the 1992 and 1993 report years), the ultimate decision finds in favor of the tax division, relying in part on an amendment to the statute made in 1993 that was termed a "clarification" of the statute.

The taxpayer in Decision 35,984¹¹¹ asserted that including receipts from the sales of certain medicine and drugs for gross receipts calculations in determining taxable earned surplus but not taxable capital is unconstitutional. Section 171.104¹¹² provides that a corporation may deduct from its receipts, for taxable capital purposes, the amount of receipts from sales of certain items (including certain health care supplies exempt from sales tax under section 151.313¹¹³) if the items are shipped from outside the state. The administrative law judge, however, concluded that because the statutory provision did not make reference to the earned surplus provision, the legislature must not have meant for the exclusion to apply to earned surplus.¹¹⁴

Consolidated Decision 35,481-35,482 and the accompanying consolidated Decision 35,477-35,478¹¹⁵ also focus on a gross receipts issue: whether the gross receipts from the taxpayer's "subscription contracts" are Texas receipts. The taxpayer develops and provides educational training and informational programming through several broadcast networks that the taxpayer operates. The programs broadcast only to subscribers, not to the general viewing public. In preparing its Texas franchise tax returns, the taxpayer treated the gross receipts from its subscriber agreements as gross receipts from intangibles, and therefore (consistent with the location of the payor rule) apportioned the receipts to the states from which the subscription contract revenue was generated. Gross receipts from video networks were allocated to the state of destination where tangible personal property was delivered. The taxpayer argued quite reasonably that the overall objective or essence of its subscription contracts is "the receipt and the right to review the programs . . . at the subscriber's locations," and that the purchase of a right to view a program is the purchase of intangible property.¹¹⁶

The tax division, which ultimately prevailed in this case, argued that "since taxpayer's product has a physical existence, i.e., either in the form of electronic signals or a tape recording, the product offered by petitioner does not fall within the definition of an intangible,"¹¹⁷ and that petitioner's programs should be treated as services. The administrative law judge concluded, perhaps more as a fact-finding than a conclusion of law, that the taxpayer's subscribers had contracted "for the performance of a

110. 34 TEX. ADMIN. CODE § 3.557(e)(37)(I).

111. Tex. Comp. Pub. Acc'ts, Hearing No. 35,984 (Jan. 5, 1998).

112. TEX. TAX CODE ANN. § 171.104 (Vernon Supp. 1998).

113. *Id.* § 151.313.

114. See Tex. Comp. Pub. Acc'ts, Hearing No. 35,984.

115. Tex. Comp. Pub. Acc'ts, Hearing Nos. 35,481-35,482 & 35,477-35,478 (July 29, 1998).

116. *Id.*

117. *Id.*

service, the preparation, production and delivery of educational programs," and had not acquired an intangible asset.¹¹⁸

The taxpayer also argued that the services were performed at the location where the programs were delivered, relying on Decision 10,028,¹¹⁹ in which the administrative law judge held that a portion of the television broadcaster's gross receipts must be allocated to New Mexico to reflect the fact that those programs were first transmitted from Texas to New Mexico. Treating this case as one of first impression, on the ground that other comptroller decisions have not addressed the issue of apportionment of gross receipts generated by services not involved in specific comptroller rules, the administrative law judge focused on determining "the essence of the agreement petitioner has made with its subscribers," and concluded that the subscribers are contracting for the provision of educational programs, and that the mode of transmission, whether broadcast live or taped production or videotape is secondary.¹²⁰ The administrative law judge ultimately determined that the services were not provided at the location where the programs were delivered.¹²¹

B. REGULATORY DEVELOPMENTS

In one of the most significant regulatory amendments of the survey period, the comptroller revised Rule 3.558,¹²² dealing with officer and director compensation as included in earned surplus computation. The amendment¹²³ changes the concept of an "officer" of a corporation (other than a banking corporation) to require add-back of such person's compensation only if that person holds an office created by the board of directors or pursuant to certain corporate organizational documents *and* has legal authority to bind the corporation with third parties by executing contracts or other legal documents.¹²⁴ The amended rule sets forth a rebuttable presumption that a person is an officer, allowing the taxpayer to rebut this presumption by showing that the person does not participate or have authority to participate in significant policymaking aspects of the corporate operations.¹²⁵ Although the amendment states that the changes "clarify" the definition of officer, these changes appear to reflect a substantial change in comptroller policy. In fact, several court and administrative cases are pending with respect to the constitutionality of the compensation add-back.¹²⁶

118. *See id.*

119. *Id.* (citing Tex. Comp. Pub. Acc'ts, Hearing No. 10,028).

120. *See id.* It is easy to imagine the frustration of the taxpayer in this case with the Decision's finding both that the essence of its transaction was not an intangible and that the essence of the transaction was the provision of educational programs.

121. *See id.*

122. 34 TEX. ADMIN. CODE § 3.558 (1998).

123. *See* 23 Tex. Reg. 6412 (199), *adopted* 23 Tex. Reg. 8462 (1998).

124. *See* TEX. ADMIN. CODE § 3.558(b)(10)(B).

125. *Id.*

126. *See* Tex. Comp. Pub. Acc'ts, Hearing No. 36,057 (Mar. 17, 1997) (focusing on a multi-tiered corporate group with an ultimate parent that was a foreign corporation); *see*

The comptroller also amended Rule 3.544,¹²⁷ concerning consolidated reports and payments, to reflect 1997 legislative changes relating to the filing of amended reports as a result of an audit by the IRS or other competent authority, or as a result of the filing of an amended IRS return or other return. The amendments added a new subsection regarding the statute of limitations for a franchise tax liability that is affected by an IRS administrative proceeding (including an audit) or a judicial proceeding, requiring a final determination affecting the franchise tax liability to be reported to the comptroller within sixty days after the determination becomes final. The rule was also amended to provide that a consolidated or combined report is not allowed.¹²⁸

The comptroller also adopted an amendment to Rule 3.545¹²⁹ to conform with 1997 legislative changes concerning extension payments made by taxpayers requesting an extension for the time in which to file an annual franchise tax report.¹³⁰

Rule 3.549¹³¹ as amended now includes a provision to reflect the legislative statement that revenues from trademarks, franchise and licenses are, for reports due on or after January 1, 1998, are included in Texas receipts to the extent used in Texas, and to provide that if services are performed inside and outside Texas, the receipts are Texas receipts "on the basis of the fair value of the services rendered in Texas."¹³²

The comptroller also amended rule 3.556¹³³ to reflect 1997 legislative changes updating the definition of the IRC and adding provisions dealing primarily with computation for a qualified subchapter S subsidiary (QSSS) and adding a definition of a QSSS. The rule provides that a QSSS will be treated as an S corporation for earned surplus computation purposes.¹³⁴

Rule 3.562,¹³⁵ concerning limited liability companies, was amended to reflect additional changes enacted by the 1997 legislature, as well as to acknowledge the "check the box" regulations issued by the IRS. These changes reflect comptroller policy on the computation of reportable federal taxable income for limited liability companies that are treated as sole

also Tex. Comp. Pub. Acc'ts, Hearing No. 36,479 (Sept. 24, 1998), in which the tax division noted that it was "not inclined to speculate on a change to rule 3.558 which has not yet been published in the Texas Register." This argument is disingenuous at best, given the frequency (e.g., in the prior contract cases, discussed *supra* at notes 7-10 and accompanying text) with which hearings attorneys rely on agency policy that has not yet been published in the *Texas Register*.

127. 34 TEX. ADMIN. CODE § 3.544 (1998).

128. *See* 23 Tex. Reg. 6144 (1998) (codified at 34 TEX. ADMIN. CODE § 3.544).

129. 34 TEX. ADMIN. CODE § 3.545 (1998).

130. *See* 23 Tex. Reg. 3012 (1998) (codified at 34 TEX. ADMIN. CODE § 3.545).

131. 34 TEX. ADMIN. CODE § 3.549 (1998).

132. 23 Tex. Reg. 3010 (1998) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.549).

133. 34 TEX. ADMIN. CODE § 3.556 (1998).

134. *See* 23 Tex. Reg. 4316 (198) (codified at 34 TEX. ADMIN. CODE § 3.556); *see also* 23 Tex. Reg. 3018 (1998). For amendments to earned surplus computation rule, *see* 34 TEX. ADMIN. CODE § 3.555 (1998).

135. 34 TEX. ADMIN. CODE § 3.562 (1998).

proprietorships, divisions or branches of corporations or corporations. For example, the rule provides that a single-member limited liability company that is treated as a divisional branch of a corporation for federal tax purposes will compute its "reportable federal taxable income" for franchise tax purposes as though the limited liability company were a separate corporation for federal income tax purposes. Thus, a single-member limited liability company that is treated as a corporate division or branch for federal income tax purposes will compute its reportable federal taxable income for franchise tax purposes in the same manner as a limited liability company that is treated as a corporation for federal tax purposes. The rule also addresses the treatment of the distributive share of income and distributions from limited liability companies treated as a division or branch of a corporation for federal income tax purposes.¹³⁶

Rule 3.568¹³⁷ was amended¹³⁸ to add a new subsection to provide that an entity that is subject to franchise tax prior to conversion, and that continues to be subject to franchise tax after conversion, will not have a new beginning date for franchise tax, and to make other changes to acknowledge the possibility of conversion from one entity to another. The rule was further amended to reflect recent legislation requiring certain entities obtain a certificate that franchise taxes have been paid prior to dissolving or withdrawing from Texas.

III. PROPERTY TAX

A. APPLICATION OF TAX/EXEMPTIONS

The Austin Court of Appeals in *Hays County Appraisal District v. Southwest Texas State University*¹³⁹ denied the public property exemption for a building and parking lot owned by a nonprofit corporation (Southwest Texas State University Foundation) and leased to a government entity (Southwest Texas State University).¹⁴⁰ The public property exemption under section 11.11 of the Tax Code¹⁴¹ exempts property owned by the state or a political subdivision of the state that is used for public purposes.¹⁴² Because there was no firm, enforceable agreement between the university and the foundation providing that legal title to the property would be transferred to the university at some time, the court concluded that the university did not have equitable title to the property and was not entitled to the public property exemption.¹⁴³ Furthermore,

136. See 23 Tex. Reg. 4317 (1998) (codified at 34 TEX. ADMIN. CODE § 3.562).

137. 34 TEX. ADMIN. CODE § 3.568 (1998).

138. See 23 Tex. Reg. 3020 (1998) (codified at 34 TEX. ADMIN. CODE § 3.568).

139. 973 S.W. 2d 419 (Tex. App.—Austin 1998, no pet.).

140. See *id.* at 423.

141. TEX. TAX CODE ANN. § 11.11 (Vernon 1992 & Supp. 1998).

142. See *id.* § 11.11(a).

143. See 973 S.W.2d at 422. The foundation and the university contended that the foundation would transfer the property to the university upon the university's payment of the mortgage on the property; however, the lease was silent on the issue of transfer of title. See *id.* In addition, the trustees of the foundation approved a resolution stating that the foundation intended to donate the property to the university upon full payment of the

the court reasoned that the property did not satisfy the "public purpose" requirement set forth in the public property exemption because the property was not used exclusively for public purposes given that twenty percent of the building and two-thirds of the parking lot were leased for activities unrelated to the university.¹⁴⁴

In another case involving principles of equitable ownership, the Amarillo Court of Appeals in *Harris County Appraisal District v. Southeast Texas Housing Finance Corp.*¹⁴⁵ held that Southeast Texas Housing Finance Corporation (Southeast) had equitable title to housing projects in which legal title was held by its subsidiaries, thereby entitling Southeast to the public property exemption on the housing projects.¹⁴⁶ Southeast, a government entity, used bond proceeds to purchase and rehabilitate housing properties. Upon acquisition, Southeast would transfer legal title to the property to a subsidiary corporation in exchange for a note secured by the property. Under the charters of each subsidiary, legal title to the properties reverts to Southeast upon full payment of the debt or upon dissolution of the subsidiary. In addition, Southeast and each subsidiary had interlocking directors. The appraisal district asserted that Southeast did not have equitable title to the properties and merely possessed a contingent remainder interest in the properties. In concluding that Southeast had equitable title to the properties, the court reasoned that the only circumstance in which there was a possibility that Southeast might not receive title is if there were a default on the bonds; however, even in this case Southeast would have had the option of curing the default or foreclosing.¹⁴⁷ Thus, the court concluded that real and beneficial use of the properties rests with Southeast.¹⁴⁸

The Attorney General in Opinion No. DM-463¹⁴⁹ addressed the free-

mortgage. *See id.* However, the court concluded that this resolution did not establish a legally enforceable obligation on the part of the foundation to transfer the property to the university. *See id.*

144. *See id.*

145. 1998 Tex. App. LEXIS 3785 (Amarillo June 24, 1998) (not designated for publication).

146. *See id.*

147. *See id.* The court's logic here seems to be tenuous given that the option to cure default and acquire ownership does not necessarily mean that Southeast would acquire ownership of the property. Indeed, if the cost to cure the default exceeded the value of the property at the time of the default, Southeast likely would not acquire the property. The court's strongest rationale, however, is that preventing Southeast from being treated as equitable owner of the property for property tax purposes would be inconsistent with the purpose of the housing finance corporation legislation, which provides that housing finance corporations and all property owned by them are intended to be exempt from property taxes. *See id.*

148. *Id.* at _____. The *Southwest Texas State Univ.* and *Southeast Texas Housing Finance Corp.* cases illustrate the importance of carefully documenting a lease or other transaction between a governmental entity and a private entity so that, if the parties so desire, the governmental entity can validly claim equitable ownership of the property for property tax purposes. In *Southwest Texas State Univ.*, the lease between the university and the foundation likely could have been written to expressly provide that ownership of the relevant property automatically transfers to the university upon payment of the mortgage without affecting the business understanding between the parties.

149. Op. Tex. Att'y Gen. No. DM-463 (1997).

port exemption under section 11.251,¹⁵⁰ which provides that property (i) that is detained in Texas for assembling, storing, manufacturing, processing or fabricating, and (ii) is transported outside Texas within 175 days after the date the owner acquired the property or imported it into Texas, is exempt.¹⁵¹ The issue presented in this opinion is whether a property owner (X) is entitled to a freeport exemption on air conditioning compressors that are sold by X to a third-party that incorporates the compressors into other goods that are then delivered outside of Texas within 175 days after X acquired the raw materials used to construct the compressors. The Attorney General concluded that the freeport exemption is not limited to property owned by a single person during the time it is in Texas.¹⁵² Thus, the compressors qualify for the freeport exemption.¹⁵³ The Attorney General noted that some portions of section 11.251 assume that freeport goods are continuously owned by one person during the time they are located in Texas; however, section 11.251(k),¹⁵⁴ the most specific provision on this issue, expressly states that property which otherwise meets the requirements of the freeport exemption is exempt regardless of whether the person who owns it on January 1 is the person who transports its outside Texas.¹⁵⁵ This opinion also implicitly indicates that the goods need not be in the same form when they leave the state that they are in when the 175-day period begins to run.¹⁵⁶

In Opinion No. DM-456,¹⁵⁷ the Attorney General concluded that a

150. TEX. TAX CODE ANN. § 11.251 (Vernon 1992 & Supp. 1998).

151. *See id.* § 11.251(b).

152. Op. Tex. Att'y Gen. No. DM-463 (1997). In a circumstance in which a property owner transfers property to another Texas property owner and the property would be eligible for the freeport exemption if the property stayed in the state for less than 175 days, it would be prudent for the transferring property owner to secure (through contract or other means) an obligation of the transferee to (i) notify the transferor with respect to how long the transferred property remains in the state with the transferee, and (ii) to provide supporting documents, so that the transferor can establish that the freeport exemption applies with respect to the transferred property.

153. *See id.*

154. TEX. TAX CODE ANN. § 11.251(k) (Vernon Supp. 1998).

155. *See* Op. Tex. Att'y Gen. No. DM-463 (1997); *see* Cynthia M. Ohlenforst, et al., *Annual Survey of Texas Law: Taxation*, 47 SMU L. REV. 1649, 1673 (1994), for a discussion of § 11.251(k).

156. In Op. Tex. Att'y Gen. No. DM-448 (1997), the Attorney General also addressed the applicability of a property tax exemption in ruling that property designated as agricultural property is not subject to rollback tax upon its acquisition by a government entity, and that a rollback tax lien is not revived upon a subsequent transfer of the property from the government entity to a taxable entity. *See id.*

157. Op. Tex. Att'y Gen. No. DM-456 (1997). Op. Tex. Att'y Gen. No. 98-001 (1998) also addressed tax abatement agreements. In this opinion, the Attorney General concluded that TEX. TAX CODE ANN. § 312.402(d) (Vernon 1992), which provides that property located in a reinvestment zone that is owned or leased by a member of the commissioners court may not be subject to a tax abatement agreement, does not apply in a circumstance in which a member of the commissioners court owns a very small percentage of shares in the publicly-held corporation entering into the tax abatement agreement. The Attorney General based his conclusion on the fact that owning such a small portion of an interest in a publicly-held corporation does not entitle the owner to effective control of such entity and that the terms "owned" and "owner" in chapter 312 of the Tax Code refer to a property interest that includes at least some degree of control over the property. *See*

county cannot amend a tax abatement agreement by deleting land from an existing reinvestment zone.¹⁵⁸ The Attorney General based his conclusion on the lack of express authority allowing for the boundaries of reinvestment zones created under chapter 312 of the Tax Code (the Tax Abatement Act¹⁵⁹) to be amended.¹⁶⁰ Conversely, chapter 311 of the Tax Code (the Tax Increment Financing Act)¹⁶¹ expressly allows for boundaries of a reinvestment zone created under that Act to be enlarged or reduced, thereby implying that the failure of chapter 312 to provide for the enlargement or reduction of boundaries of reinvestment zones created under chapter 312 means that such zones cannot be amended.¹⁶² The Attorney General also concluded that property within a county reinvestment zone under chapter 312 must be contiguous,¹⁶³ that a reinvestment zone under chapter 312 cannot include all or a part of a building unless the zone includes the land on which the building is located,¹⁶⁴ and that a reinvestment zone under chapter 312 cannot include only a floor of a multi-story building.¹⁶⁵ The Attorney General reached these conclusions largely because the terms “zone” and “area” as used in Chapter 312 commonly refer to a parcel of land or a portion of the earth’s surface and not portions of improvements.¹⁶⁶

id. The conclusion makes sense given that any other result would make it difficult for some publicly-held corporations whose stock is widely held to enter into tax abatement agreements.

158. *See id.* It is unclear why the commissioners court desired to delete property from the reinvestment zone. It is possible that the county desired to delete the property so that it could be placed in a different reinvestment zone, which would allow for differing abatement terms than applied to property in the original reinvestment zone. With certain exceptions, agreements made with owners of property in a reinvestment zone must contain identical terms as to the portion of the value of the property that is to be exempt and the duration of the exemption. *See* TEX. TAX CODE ANN. § 312.204(b) (Vernon 1992). It may be possible, however, to achieve the same result by having the taxing entity and the property owner enter into an economic development agreement under section 380.001 or 381.004 of the Local Government Code. *See* TEX. LOCAL GOV'T. CODE ANN. §§ 380.001 and 381.004 (Vernon Supp. 1999).

159. TEX. TAX CODE ANN. §§ 312.001-312.402 (Vernon 1992 & Supp. 1998).

160. Op. Tex. Att'y Gen. No. DM-456 (1997).

161. TEX. TAX CODE ANN. §§ 311.001-311.017 (Vernon 1992 & Supp. 1998).

162. *See* Op. Tex. Att'y Gen. No. DM-456 (1997).

163. *See id.*

164. *See id.*

165. *See id.* If a government entity and a taxpayer desire for a separate floor of a building to have a different property tax exemption, or a different term, than other floors of the property, it may be possible to enter into an economic development agreement under the Texas Local Government Code to achieve such a result. *See* TEX. LOCAL GOV'T CODE ANN. §§ 380.001 & 381.004 (Vernon Supp. 1999).

166. *See id.* The court did not address whether two separate reinvestment zones could apply to a single property in a circumstance in which the property is divided vertically or horizontally, e.g., the north end of the building is in one reinvestment zone, and the south end of the building is in another reinvestment zone. Based on the rationale applied by the Attorney General, this type of action should be allowed by chapter 312 of the Tax Code given that each portion of the building sits on property which could be divided into separate parcels of property.

B. PROCEDURE

In *Motorola, Inc. v. Tarrant County Appraisal District*,¹⁶⁷ the Fort Worth Court of Appeals upheld the constitutionality of section 11.251(h) of the Tax Code.¹⁶⁸ Section 11.251(h) provides that an appraisal district may request a taxpayer claiming the freeport exemption to supply the appraisal district with copies of inventory or property records to determine amount of the freeport exemption.¹⁶⁹ The statute further provides that failure to do so within thirty days after request results in the property owner forfeiting the exemption.¹⁷⁰ In this case, Motorola claimed the freeport exemption but failed to provide the appraisal district any information supporting its claim of freeport exemption within thirty days after request. The district court granted the appraisal district summary judgment concerning the exemption because it concluded that Motorola forfeited the exemption for failure to timely comply with section 11.251(h).¹⁷¹ Motorola asserted that section 11.251(h) is unconstitutional because it arbitrarily forfeits the constitutionally-mandated freeport exemption in violation of the equal protection clause of the Fourteenth Amendment.¹⁷² The court of appeals disagreed, reasoning that it is not constitutionally unreasonable or arbitrary to place a thirty-day deadline on filing supporting documentation.¹⁷³

In *Atascosa County v. Atascosa County Appraisal District*,¹⁷⁴ two school districts sought to compel the appraisal district to revoke retroactively the charitable exemption of a hospital for the previous five years because the hospital had been during that period leased to for-profit organizations. The school districts asserted that sections 11.43(i) and 25.21 of the Tax Code¹⁷⁵ authorize the school districts to compel reconsideration of the exemption for the previous five years. Section 11.43(i) provides that if the chief appraiser discovers that an exemption that is not required to be claimed annually has been allowed erroneously in any one of the five preceding years, the chief appraiser shall add to the tax roll the property or appraised value that was erroneously exempted.¹⁷⁶ Section 25.21 sets forth a similar provision for property omitted from the tax

167. 980 S.W.2d 899 (Tex. App.—Fort Worth 1998, no pet.).

168. TEX. TAX CODE ANN. § 11.251(h) (Vernon 1992).

169. *See id.*

170. *See id.*

171. *See* 980 S.W.2d at 901.

172. Motorola also argued that the freeport exemption is self-executing and thus immune from statutory limitations such as that provided in section 11.251(h). In response, the court of appeals stated that although the exemption is self-executing, the framers did not include any procedures for a taxpayer to establish its rights to the exemption, and, therefore, the Texas Legislature is free to prescribe such rules. *See id.* at 902.

173. *See id.* at 903. As the court noted, in the absence of a deadline, the exemption determination process could go on indefinitely, which would clearly frustrate the purpose of the exemption and the administration of the Tax Code.

174. 962 S.W.2d 188 (Tex. App.—San Antonio 1998, pet. granted) (This case was reversed in part after the Survey period. *See* 1999 Tex. LEXIS 34 (Tex. 1999)).

175. TEX. TAX CODE ANN. §§ 11.43(i) & 25.21 (Vernon 1992 & Supp. 1998).

176. *See id.* § 11.43(i) (Vernon Supp. 1998).

roll.¹⁷⁷

The trial court granted summary judgment for the appraisal district and the hospital, concluding that the only relief the school districts were entitled to was denial of the exemption for the current year, and that retroactive relief was barred by limitations and lack of standing.¹⁷⁸ The San Antonio Court of Appeals agreed with the trial court.¹⁷⁹ The court of appeals considered section 41.04,¹⁸⁰ which provides that a taxing unit cannot challenge an action by the appraisal district unless the challenge is initiated before June 1 or within fifteen days after the date the appraisal records are submitted to the appraisal review board, whichever is later.¹⁸¹ Given that section 41.04 limits the time taxing units may act to challenge an appraisal district action, and that sections 11.43(i) and 25.21 appear to be within the exclusive province of the chief appraiser, the court reasoned that retroactive relief is not available to the school districts. The court also concluded that nothing had been “discovered,” since the exemptions were originally granted which would warrant revoking the exemption retroactively.¹⁸² There was no evidence that the status of the hospital’s property was unknown to or overlooked by the chief appraiser.¹⁸³

The Texas Supreme Court in *Clint Independent School District v. Cash Investments, Inc.*,¹⁸⁴ considered a challenge to a purchase at a tax foreclosure sale. In this case, the delinquent tax judgment was almost \$67,000 and the market value of the property as determined by the court was approximately \$1.1 million. At the foreclosure sale, a third-party purchased the property for \$360, the highest bid. The taxing unit challenged the sale based on section 33.50(b) of the Tax Code,¹⁸⁵ which provides that the property “may not be sold to the property owner or to any party to the suit, other than a taxing unit, for less than its market value or the delinquent taxes, whichever is less.”¹⁸⁶ Although the literal wording of section 33.50(b) does not apply to a purchaser that is not the property owner or a taxing unit, and thereby does not literally place a limit on what the bid and sales price can be as to such third-party purchasers, the court relied on legislative history in concluding that section 33.50(b) should be read to limit the amount for which a third party may purchase a

177. See *id.* § 25.21 (Vernon 1992).

178. See 962 S.W.2d at 189.

179. See *id.* at 192.

180. TEX. TAX CODE ANN. § 41.04 (Vernon 1992).

181. See *id.*

182. See 962 S.W.2d at 191.

183. The court also concluded that it was not error for the lower court to consider a letter from the Comptroller’s office that addressed the statutory interpretation issues at hand. See *id.* at 192. The Court noted that such letters are not binding, but can be considered seriously by a court. Query whether the court’s statement that such letters can be seriously by a court may spur appraisal districts and other taxing entities to lobby the Comptroller’s office to write letters to courts supporting the taxing units’ position, and query whether such letters should be considered by the court.

184. 970 S.W.2d 535 (Tex. 1998).

185. TEX. TAX CODE ANN. § 33.50(b) (Vernon Supp. 1998).

186. *Id.*

property at a tax foreclosure sale.¹⁸⁷ The phrase "to the suit" was added in 1979 to section 33.50(b) when the tax provisions were codified. Before this, the provision clearly prevented all purchasers from purchasing for less than the lesser of market value or the delinquent taxes. Because there was no mention in the legislative history of section 33.50(b) that it was being amended to allow third parties to purchase for less than market value or delinquent taxes, the court concluded that the legislature did not intend to make substantive changes when it recodified section 33.50(b).¹⁸⁸ In addition, the court concluded that interpreting section 33.50(b) to allow for purchases below fair market value or delinquent taxes would be inconsistent with section 34.01(c),¹⁸⁹ which provides that if a sufficient bid is not received, the property shall be bid off to a taxing unit that is a party to the judgment for the aggregate delinquent taxes or the property's market value, whichever is less. The court reasoned that a "sufficient bid" must be a minimum bid under section 33.50(b), and if section 33.50(b) did not have a minimum bid requirement for third parties, section 34.01(c) would be a nullity.¹⁹⁰

The decisions in *G.E. American Communication v. Galveston Central Appraisal District*¹⁹¹ and *GE Capital Corp. v. Dallas Central Appraisal District*¹⁹² demonstrate a split concerning the standard of review of appeals made under section 25.25 of the Tax Code.¹⁹³ Section 25.25(c)¹⁹⁴ provides that at any time before the end of five years after January 1 of a tax year, the appraisal review board, on motion of either the appraisal district or a property owner, may direct changes in the tax roll to correct certain clerical errors, multiple appraisals of a property in the same year, and the inclusion of property on the tax roll that does not exist in the form or at the location described in the tax roll.¹⁹⁵ Section 25.25(g)¹⁹⁶ provides that a property owner or the appraisal district may sue to compel the appraisal review board to order a change in the appraisal roll.¹⁹⁷

In *G.E. American*, the Houston [14th Dist.] Court of Appeals reversed its 1995 decision in *Harris County Appraisal District v. World Houston, Inc.*,¹⁹⁸ and concluded that an appeal under section 25.25(g) requires a substantive review of the proceedings rather than merely the review of whether procedural due process occurred at the appraisal review board

187. See 970 S.W.2d at 538-39.

188. See *id.* at 539.

189. TEX. TAX CODE ANN. § 34.01(a) (Vernon 1992).

190. See 970 S.W.2d at 539. This interpretation seems to be a stretch. Section 34.01(c) would not be a nullity if it did not apply to third party purchases because the section would still be applicable to purchases by the property owner or a taxing unit.

191. 979 S.W.2d 761 (Tex. App.—Houston [14th Dist.] 1998, no pet.).

192. 971 S.W.2d 591 (Tex. App.—Dallas 1998, no pet.).

193. TEX. TAX CODE ANN. § 25.25 (Vernon 1992 & Supp. 1998).

194. *Id.* § 25.25(c) (Vernon 1982).

195. See *id.*

196. *Id.* § 25.25(g).

197. See *id.*

198. 905 S.W.2d 594 (Tex. App.—Houston [14th Dist.] 1995, no writ).

level.¹⁹⁹ The court changed its mind because of a 1997 amendment to section 42.01,²⁰⁰ which provides that determinations of an appraisal review board under section 25.25 are appeals.²⁰¹ Although this amendment was not effective for the year at issue, the court concluded that the use of the term “appeal” in the amendment is evidence that the legislature intended section 25.25(g) to serve as an appeal in the traditional sense and not merely a review process to determine whether procedural requirements have been met. The court concluded, however, that a pure de novo review is not the appropriate standard in a section 25.25(g) appeal. Rather, the court held that the proper standard of review, prior to the amendment to section 42.01, was substantial evidence de novo, which gives a level of deference to the appraisal review board’s decision while still allowing an unbiased party to review the decision.²⁰² The Dallas Court of Appeals in *GE Capital Corp.*, however, concluded that trial de novo is the appropriate standard, even before the 1997 section 42.01 amendments, without considering whether the substantial evidence de novo standard should apply.²⁰³

IV. PROCEDURE AND LIABILITY

The court of appeals recently addressed a statute of limitations issue relating to refunds sought following the case of *Bullock v. Sage Energy Co.*,²⁰⁴ in which the court held that the comptroller’s method of determining franchise tax liability was unconstitutional. The taxpayer in *Overhead Door Corp. v. Sharp*,²⁰⁵ had requested a refund of franchise taxes paid in the years 1986 and 1987. The comptroller issued a refund check to the taxpayer in the amount requested by the taxpayer, less forty-six percent to account for federal income taxes. Several years later the taxpayer requested a refund of the additional forty-six percent. The comptroller refunded the additional amount for the 1987, year but determined that the 1986 year claim was barred by the statute of limitations. The taxpayer argued that the four-year limitations period was tolled by its original refund request and that the comptroller’s issuance of a refund check did not stop the tolling.

The court held that the comptroller’s issuance of a refund check and the taxpayer’s acceptance of the check without reservation constituted the comptroller’s informal decision on the initial refund claim and the limitations period had again begun to run.²⁰⁶ This analysis was not affected by the fact that the refund check was issued for less than the amount requested. The taxpayer also alleged a constitutional violation of

199. See 979 S.W.2d at 774.

200. TEX. TAX CODE ANN. § 42.01 (Vernon Supp. 1998).

201. See 979 S.W.2d at 773-75.

202. See *id.*

203. See 971 S.W.2d at 594.

204. 728 S.W.2d 465 (Tex. App.—Austin 1987, writ ref’d n.r.e.)

205. 970 S.W.2d 74 (Tex. App. —Austin 1998, no pet.).

206. See *id.* at 79.

the right to fair and equal taxation based on the comptroller's settlement of a similar case. However, the court found no constitutional violation, and held that the attorney general has broad discretion in settling cases, and that the decision not to settle this particular case was not an abuse of discretion.²⁰⁷

The court of appeals also reviewed the statute of limitations applicable to taxpayers seeking a refund of sales and use tax based on vendor assignments. The court held in *Fleming Foods v. Sharp*²⁰⁸ that refund claims may be barred by the statute of limitations if the comptroller and the vendors have not entered into a waiver of the statute. The taxpayer in *Fleming Foods* and the comptroller had entered into an agreement extending the time period for the taxpayer to file tax refund claims. The comptroller denied the refunds that were outside the original limitations period, reasoning that the original statute of limitations could not be extended without a waiver agreement between the comptroller and the vendors.²⁰⁹ The Texas Supreme Court, which originally denied Fleming Foods' Petition for Review, granted its Petition in September 1998, but has not issued a decision by the time this survey article went to press.

In *Formosa Plastics v. Sharp*,²¹⁰ the taxpayer paid the estimated tax liability following its receipt of a bill for the deficiency assessment. Because the payment exceeded the audit assessment, no formal Notice of Tax was issued, although the comptroller sent the taxpayer an audit report that stated the audit assessment and acknowledged receipt of the payment. More than four years later, Formosa claimed a refund. Although part of the refund was granted, the comptroller denied a portion of the refund claim based on his conclusion that the statute of limitations had run. The district court ruled against Formosa Plastics, and the appeals court affirmed the lower court's judgment.²¹¹

In *Stoker Management, Inc. v. Sharp*,²¹² a janitorial services franchisor was held liable for sales tax on services performed by its franchisees. Generally, the franchisor collected payments, including sales taxes, from the franchisee's customers. Upon receipt, the franchisor took its royalty payment from the amount received and sent the remainder, including sales tax, to the franchisee. In determining that the franchisor was liable for remitting taxes to the state, the court held that the franchisor is not required to be a seller or retailer for the trust fund provisions of section 111.016²¹³ to apply.²¹⁴ Despite this holding, the court further found

207. See *id.* at 80.

208. 951 S.W.2d 278 (Tex. App.—Austin 1997, writ granted). See generally Ohlenforst, 1998 Annual Survey, *supra* note 2.

209. See Ohlenforst, 1998 Annual Survey, *supra* note 2, at 1379, for a more complete discussion of this case.

210. 979 S.W.2d 410 (Tex. App.—Austin 1998, pet. denied).

211. *Id.* This is one of several 1998 cases in which the court of appeals has declined to hear oral arguments, notwithstanding a party's request for oral argument.

212. 958 S.W.2d 286 (Tex. App.—Austin, 1997, pet. denied).

213. TEX. TAX CODE ANN. § 111.016 (Vernon 1992 & Supp. 1998).

214. See 958 S.W.2d at 289.

that based on the franchisor's activities, the franchisor was a seller under the statute.

Decision 37,260²¹⁵ is one of several penalty cases issued during the last year. Although unremarkable in its facts, the case is worth discussion because it focuses on the comptroller's view that once an auditor has indicated to a taxpayer that its tax treatment is incorrect and explained the comptroller's view of how the taxes should be reported, "then the taxpayer must report that way, or, face imposition of a penalty if it does not, unless it is vindicated in its choice."²¹⁶ In upholding this position and concluding that a taxpayer must report its taxes in accordance with an audit until vindicated, the comptroller essentially requires a taxpayer to choose between a penalty (if the comptroller's position is ultimately upheld) or making an interest-free loan to the state (if the taxpayer's position is ultimately upheld). Given the fact that Texas does not pay interest on tax refunds granted pursuant to administrative hearings, requiring the taxpayer to make this Hobson's Choice seems inequitable.

More often than not, taxpayers who challenge penalties appear to be losing their cases. Even when taxpayers win in the beginning, they may lose in the end. In Decision 35,445,²¹⁷ for example, the comptroller's proposed decision concluded that the taxpayer was subject to the ten percent "regular penalty," but not to the fifty percent penalty under section 111.061(b).²¹⁸ This case involved a taxpayer who failed to "do the right thing" (because it collected and failed to remit taxes), then tried to do the right thing (by notifying the comptroller of its error in connection with the comptroller's audit of a related company); nonetheless, the taxpayer ultimately lost and was required to pay the fifty percent penalty. Although the taxpayer apparently did not intend to retain permanently the taxes it had collected from Texas customers, and apparently did intend to pay them once it could determine more accurately how much money had been remitted and paid, the (bad) fact remained that the taxpayer had collected and failed to remit taxes.²¹⁹

Decision 36,229²²⁰ reiterates the comptroller's view that a motion to dismiss a petition for redetermination serves as no precedential value and is essentially "not authority for anything."²²¹ To the extent the comptroller's office continues to follow this policy, it may force taxpayers to insist on a hearing decision that recites the agreement of the parties rather than dismissing the petition on the basis of a motion to dismiss.

215. Tex. Comp. Pub. Acc'ts, Hearing No. 37,260 (July 15, 1998).

216. *Id.*

217. Tex. Comp. Pub. Acc'ts, Hearing No. 35,445 (July 8, 1998).

218. TEX. TAX CODE ANN. § 111.016(b) (Vernon Supp. 1998).

219. The taxpayer had relied on a third party billing company to collect tax from its Texas customers, but the billing company's records did not provide the taxpayer with sufficient data to determine the precise amount of tax to be paid to each locality.

220. Tex. Comp. Pub. Acc'ts, Hearing No. 36,229 (Sept. 4, 1998).

221. *Id.*

